BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Address the Gas Utilities' Incentive Mechanisms and the Treatment of Hedging Under Those Incentive Mechanisms.	Rulemaking 08-06-025 (Filed June 26, 2008)

REPLY COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES

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October 17, 2008

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I. INTRODUCTION

Pursuant to the September 17, 2008 Assigned Commissioner's and Administrative Law Judge's Ruling Providing Schedule and Scoping Memo (ACR), the Division of Ratepayer Advocates (DRA) hereby files its reply comments on issues identified in the Order Instituting Rulemaking to Address the Gas Utilities' Incentive Mechanisms and the Treatment of Hedging Under Those Incentive Mechanisms (OIR) filed June 26, 2008.

II. DISCUSSION

The OIR describes in narrow terms the issues to be considered in this proceeding regarding prospective changes to the gas utilities' incentive mechanisms and the treatment of hedging under those incentive mechanisms. The ACR affirmed the scope of the proceeding as set forth in the OIR.[1] DRA submits these reply comments to the opening comments filed by Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E), Southwest Gas Corporation (Southwest), and Shell Energy North America (US), LP (Shell) on the OIR.

[1] ACR, p. 7.

III. RESPONSE to PG&E

A review of the opening comments shows the basic philosophical difference regarding gas procurement hedging between PG&E and DRA. PG&E states that, "the decision to hedge is a matter of policy that should ultimately reflect the Commission's interpretation of customer risk preferences."[2] It is this PG&E position with which DRA takes issue and where the two parties differ on policy. DRA maintains that hedging should be re-integrated into the incentive mechanism since it should be a discretionary decision of the utility whether to hedge; and that the utility should share the risk of this discretionary decision. On the other hand, PG&E asserts that hedging should be an established Commission policy, but it is noteworthy that the winter hedge programs (outside the CPIM) were originally initiated and advanced through utility requests. DRA questions the wisdom of a static policy, applied to a dynamic market, based on interpretation of some perceived or implied customer risk preference. The decision to hedge should be based on evolving gas market conditions on a real-time basis which further supports hedging costs being re-integrated into the incentive mechanisms.

PG&E asserts that, "Any actions taken to hedge customer risk under the CPIM would result in an unhedged or speculative position for the utility"[3], since deviation from the monthly index creates risk for the utility under CPIM. This is not entirely accurate since the tolerance bands within the incentive mechanisms serve to mitigate such exposure. These tolerance bands, in conjunction with the utilities own discretionary decision whether and to what extent to undertake any hedging, serve to limit any utility/shareholder exposure to risk. All procurement risk including hedging is ultimately balanced within the incentive mechanism since it is shared by the utility and its ratepayers, while providing utility shareholders a reasonable level and measure of added protection through the tolerance bands.

[2] Opening Comments of PG&E on OIR Issues, p. 6.

[3] Opening Comments of PG&E on OIR Issues, p. 6.

The stated intent of PG&E's hedge program is to reduce customers' exposure to price risk or price volatility. The initiation and pursuit of this policy in Commission proceedings by PG&E strongly implies some related corporate benefits (e.g. contribution to better public relations). In reducing customers' exposure to price risk or volatility, PG&E may mitigate (what it perceives as) any negative public and customer reaction related to the occurrence of a low probability, high cost event. If hedging is included within the CPIM, any and all benefits and risks (be they primary, secondary, or tertiary; and quantitative or qualitative) of the decision and expenditures are properly shared by the customers and shareholders.

PG&E states that when the incentive mechanisms were developed for SDG&E, SoCalGas and PG&E, gas markets were less volatile and hedging was less important; and that, "since the winter of 2000-2001, gas price volatility has risen tremendously requiring substantially more hedging in order to adequately protect gas customers from extreme price run-ups."[4] DRA agrees that gas prices are higher today compared to when the incentive mechanisms were developed[5], but PG&E presents no factual evidence to support its statement that gas price "volatility" has risen tremendously.

IV. RESPONSE to SOCALGAS and SDG&E

With respect to the issue of a separate hedging incentive mechanism, SoCalGas and SDG&E state, they "do not believe that an incentive mechanism for winter hedging is an absolute necessity" and they "do not have a specific new incentive proposal at this time, but we are carefully considering the concept."[6] DRA opposes the concept of a separate hedging incentive mechanism as set forth in its opening comments. PG&E agrees stating, "PG&E does not believe at this time that a separate incentive mechanism

[4] Opening Comments of PG&E on OIR Issues, p. 9.

[5] This evidence is available through DRA's Annual Monitoring and Evaluation Reports on the gas incentive mechanisms of PG&E, SoCalGas and SDG&E.

[6] Opening Comments of SoCalGas and SDG&E on OIR, p. 8.

can be designed that aligns customer and shareholder interests in a fair and economically efficient manner."[7]

In its comments, SoCalGas and SDG&E provide no evidence to support the viability of a separate hedging incentive mechanism. Rather, the OIR parties are placed on notice that, "SoCalGas and SDG&E are currently working to determine whether we can develop a new workable incentive proposal for SoCalGas and SDG&E" and they "hope to present ideas on incentives at the second technical workshop in this proceeding on November 17, 2008."[8] Although relieved that no half-baked concepts were advanced in opening comments, parties must now contend with SoCalGas and SDG&E's newly announced slow bake process by which they "hope to present ideas" at a future workshop. Nonetheless, DRA awaits any new hedging recipes SoCalGas and SDG&E ultimately cook up on this matter and unveil at the workshop.

SoCalGas/SDG&E recognize that, "there are explicit guidelines associated with our winter hedging plans", but assert that the challenge is "developing an appropriate market benchmark that actually reward prudent management of an approved winter hedging program." If SoCalGas/SDG&E seek rewards in this regard, then they merely need to support reintegrating hedging into the existing incentive mechanisms as proposed by DRA in its opening comments.

V. RESPONSE to SOUTHWEST

In its opening comments, Southwest asserts that some small changes to its existing GCIM may be desirable. According to Southwest, one such revision may be to modify the GCIM and hedging program to include the use of fixed-for-floating index swaps and another possible change is to re-examine the percentage of Southwest's purchases that are currently included in its hedging program. Southwest alleges that it may be desirable to increase the hedged percentage to somewhere between 25 and 50 percent to bring it inline

[7] Opening Comments of PG&E on OIR Issues, p. 8.

[8] Opening Comments of SoCalGas and SDG&E on OIR, p. 9.

with Southwest's hedging activities in its Arizona and Nevada jurisdictions where about 50 percent of the portfolio is hedged.

The basis for Southwest's desire to increase the hedged percentage of its purchases above 25% is to be consistent with its hedging activities in Arizona and Nevada. Southwest fails to provide any factual evidence to show that its ratepayers in California would benefit from this change. If truly interested in pursuing this change, Southwest can present information from its Nevada and Arizona jurisdictions to show the ratepayer benefits associated with such a policy and why it should be applied to its California jurisdiction in an appropriate venue. The information and evidence can be properly evaluated, analyzed and responded to by other parties such as DRA, and ultimately considered by the Commission.

DRA opposes the changes suggested by Southwest because they are beyond the stated scope of the OIR which was reiterated in the ACR. The ACR states, "This rulemaking is not intended to be a broad reexamination of the utilities' gas incentive mechanisms. Each year these incentive mechanisms go through an application process where there is an opportunity to propose modifications." Southwest's changes should be properly developed and addressed in an appropriate proceeding, but they are not within the scope of this OIR.

VI. RESPONSE to SHELL

Shell proposes that the Commission establish a transparent, nondiscriminatory solicitation protocol through which the utilities seek bids or offers for hedge products. DRA opposes the Shell proposal. Absent some clear benefit to core customers, there is no factual basis to establish the solicitation protocol proposed by Shell. Core purchases represent less than 50% of the gas sold in the California market, while the balance of gas supply is generally moved into the market by noncore customers and/or marketers/producers. Shell's proposal would create a double standard in the gas market – "full disclosure" of hedge products for the utilities, and "no disclosure" for all other market participants (marketers, producers, large end-users, core aggregators, etc). Shell fails to justify why utilities (buying gas for its core customers) should be compelled by regulators to establish a transparent, nondiscriminatory "full disclosure" solicitation protocol for hedge products, while the rest of the market would not be covered within this stated regulatory protocol.

Shell asserts that its proposed solicitation process will increase the range of potential products. The gas market is a competitive and creative market with a vast range of products already available; and is very capable of developing new products when there is a demand for them. Shell fails to provide any meritorious arguments or quantification of any ratepayer benefits that could conceivably result from its proposed protocol. Shell's solicitation protocol proposal should be rejected.

Shell proposes significant changes to the existing incentive mechanisms. The proposals are presented in conceptual terms with very little detail. For example, Shell suggests that the incentive mechanism include a "portfolio price volatility target" but provides little in terms of details of how it would be calculated and fit into the mechanisms. Absent the specific details, it is difficult to evaluate the proposal and determine whether it properly advances and balances both ratepayer and shareholder interests. The proposed changes would clearly encompass more complexity and uncertainty in contrast to the existing mechanisms. Generally, more complexity and uncertainty poses greater risk and the potential for higher ratepayer costs. Shell fails to quantify any ratepayer benefits of its proposed changes to the incentive mechanisms relative to the current incentive mechanisms. Furthermore, the wholesale changes to the procurement incentive mechanisms proposed by Shell appear to be beyond the scope of the OIR. In its opening comments, DRA provided clear evidence of the ratepayer benefits associated with current incentive mechanisms over the past 14 years and why they should be retained in the current form (with reintegration of hedging costs). The changes to the incentive mechanisms proposed by Shell should be rejected.

VII. CONCLUSION

For the reasons set forth in its opening and reply comments, DRA recommends the following:

- All hedging costs should be re-integrated in the gas procurement incentive mechanisms for SoCalGas/SDG&E and PG&E. No other modification of the existing incentive mechanisms is required.
- If winter hedging costs remain outside the gas incentive mechanisms then utilities should seek annual approval of the hedge plans through advice letter or application as described in its opening comments. Further, the SoCalGas/SDG&E GCIM sharing formula for rewards should be modified to 80% ratepayers/20% shareholders to reflect the reduced risk consistent with the PG&E CPIM.
- No separate mechanism should be designed to create an incentive to manage hedging program costs outside the existing procurement mechanisms.
- No generic statewide hedging guidelines and policies are required beyond appropriate reporting and disclosure requirements to the Commission and DRA.

Respectfully submitted,

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October 17, 2008

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **"REPLY COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES"** in **R.08-06-025** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

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Executed on October 17, 2008 at San Francisco, California.

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